

Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Effect of Closing Agreement on the taxpayer's LIFO definition of an item

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

This opinion is based on the facts set forth herein. Should you determine that the facts are different, you should not rely on this opinion without conferring with this office, as our opinion may change. Further, this opinion is subject to post-review in the National Office. That review might result in modifications to the conclusions herein. Should the National Office suggest any material change in the advice, we will notify you as soon as we hear from that office.

LEGEND

Taxpayer	=
Parent	=
Company A	=
Company B	=
Company C	=
Company D	=
Division 1	=
Date 1	=
Date 2	=

Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Year 1	=
Year 2	=
Year 3	=
X	=
Paragraph A	=
Paragraph B	=
Attachment Y	=
Name 1	=
Name 2	=
Name 3	=
Pool A	=

ISSUES

Whether a Closing Agreement executed in a prior tax year bars the Internal Revenue Service ("IRS") from changing the taxpayer's¹ LIFO definition of an item.

CONCLUSIONS

The Closing Agreement does not prevent the IRS from changing the taxpayer's LIFO definition of an item for tax years after Year 1. The language of the Closing Agreement does not reflect an agreement between the parties as to the appropriateness of the taxpayer's LIFO item definitions or the permissibility of such item definitions in future years.

FACTS

The taxpayer uses a dollar-value, last-in first-out ("LIFO") inventory accounting method. During Year 3, the Parent² and the Commissioner of Internal Revenue executed a Closing Agreement on Final Determination Covering Specific Matters.³ The Closing

¹ In this memorandum, "the taxpayer" refers to the Taxpayer (formerly known as Company A).

² The Parent executed the agreement on behalf of itself and as the agent for Company A.

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Agreement relates to the LIFO basis of Company A's Pool A. The Commissioner disputed the LIFO value of Company A's Pool A as valued as of Date 1, Date 2, Date 3, Date 4, Date 5, Date 6, and Date 7. The Commissioner determined a LIFO value as of Date 7 of \$X. The taxpayer agreed to accept the Commissioner's LIFO computations.

One of the Closing Agreement's introductory clauses states,

In the determination and agreement section of the Closing Agreement, Paragraph A provides:

Paragraph B provides that

The Closing Agreement was signed by an examination manager, Name 1, on behalf of the Commissioner on Date 10. An Internal Revenue Agent, Name 2, signed the Closing Agreement on Date 8, as the receiving officer and in affirmation of the statement "I have examined the specific matters involved and recommend the acceptance of the proposed agreement." A Case Manager, Name 3, signed the Closing Agreement on Date 9, as the reviewing officer and in affirmation of the statement "I have examined the specific matters involved and recommend the approval of the proposed agreement."

On Date 11, Company A changed its name to the Taxpayer. On the same date, Company B merged into the Taxpayer. On Date 12, the assets of Company C Division 1 were transferred to the Taxpayer in a tax-free transfer under Internal Revenue Code section 351. Currently, such assets are owned by Company D, which is a single-

member limited liability company owned solely by the Taxpayer. The merger and section 351 transfer resulted in a combination of the LIFO pools of these entities. In general, the methods employed by the Taxpayer represent the predominant accounting methods for purposes of section 381.

The taxpayer takes the position that Paragraph A of the Closing Agreement bars the IRS from changing the way the taxpayer defines items for LIFO purposes. The IRS believes that the taxpayer's item definitions may be too broad and wants to examine this issue during the current audit cycle.

LAW AND ANALYSIS

LIFO Method of Valuing Inventory

A general understanding of the LIFO accounting method is necessary to determine the appropriate interpretation of the Closing Agreement.

"Section 471 requires the use of inventories whenever necessary in order to clearly reflect income." Richardson v. Commissioner, T.C. Memo. 1996-368. Section 472 allows taxpayers to value inventories using the LIFO convention, which treats the last goods acquired as the first goods sold (i.e., the earliest purchased goods remain in closing inventory). See Hamilton Indus., Inc. v. Commissioner, 97 T.C. 120, 130 (1991) (citing I.R.C. § 472(b)(1)). "By matching the cost of the most recently purchased goods with current sales revenue, the LIFO convention removes from current earnings any artificial profits attributable to inflationary increases in inventory costs." Id. There are two principal methods for computing inventory under the LIFO convention: (1) specific goods method and (2) the dollar value method. The former measures inventory by identifying and counting individual units. See Treas. Reg. § 1.472-2. The latter measures inventory in terms of dollars rather than specific units. See Treas. Reg. § 1.472-8.

Under the dollar-value LIFO method, goods in inventory are grouped into one or more pools. See Treas. Reg. § 1.472-8. Each pool contains one or more classes of goods referred to as "items." See Treas. Reg. § 1.472-8. Changes in inventory are calculated based on changes in the dollar value(s) of the pool(s). See Hamilton Indus., Inc., 97 T.C. at 130-31. Whether there is an increment or decrement in inventory during the year is "determined by comparing the aggregate base-year cost of the items in a pool at the beginning of the year to the aggregate base-year cost of the items in the pool at the end of the year." Huffman v. Commissioner, 126 T.C. 322, 328 (2006). The "base-year cost" is the cost of an item as of the base date, which "is the first day of the first year for which LIFO is adopted." Id.

Neither the Code nor the applicable regulations define "item," but the Tax Court in Amity Leather Products Co. opined that a narrower definition will provide a more accurate measure of inflation, although the Court acknowledged that the definition of "item" must

be administratively feasible and not unduly burdensome. 82 T.C. at 734. A narrower definition of item more clearly reflects income because it prevents factors other than inflation from entering inventory. See id. at 733-34. The Tax Court gave the following example in Amnity Leather Products Co. to illustrate this point:

[I]f a taxpayer's inventory experiences mix changes that result in the substitution of less expensive goods for more expensive goods, the treatment of those goods as a single item increases taxable income. This occurs because any inflation in the cost of an item is offset by the reduction in cost resulting from the shift to less expensive goods. Conversely, if changes in mix of the inventory result in the substitution of more expensive goods for less expensive goods, the treatment of those goods as a single item decreases taxable income because the increase in inventory costs is eliminated from the LIFO costs of the goods as if such cost increase represented inflation.

Id. at 733.

Therefore, a LIFO calculation is affected by the pools and items used by a taxpayer, as well as the costs of the items in a pool. In light of this, the statement in the Closing Agreement that

is meant to lock-in the taxpayer's pre-Year 2 LIFO calculations and the data affecting such calculations, not to establish the suitability of item definitions going forward. In fact, nothing in the agreement references the taxpayer's item definitions in the context of the appropriateness of such definitions or otherwise indicates that this was an issue the Closing Agreement was meant to resolve. As will be discussed below, the language of the agreement does not support the taxpayer's interpretation.

Closing Agreements

Internal Revenue Code section 7121(a) authorizes the Secretary to enter into closing agreements "with any person relating to the liability of such person . . . in respect of any internal revenue tax for any taxable period." Section 7121(b) provides that

If such agreement is approved by the Secretary (within such time as may be stated in such agreement, or later agreed to) such agreement shall be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact –

(1) the case shall not be reopened as to the matters agreed upon or the agreement modified by any officer, employee, or agent of the United States, and

(2) in any suit, action, or proceeding, such agreement, or any determination, assessment, collection, payment, abatement, refund, or credit made in accordance therewith, shall not be annulled, modified, set aside, or disregarded.

Treasury Regulation section 301.7121-1(b)(3) provides that closing agreements may be with respect to taxable periods ending subsequent to the date of the agreement. In such cases, "the agreement may relate to one or more separate items affecting the tax liability of the taxpayer." Treas. Reg. § 301.7121-1(b)(3).

Therefore, the Closing Agreement is binding if it was properly executed in accordance with section 7121 and the regulations thereunder, and, if binding, would bar the Commissioner from changing the taxpayer's item definitions if the parties so agreed in the Closing Agreement.

Interpretation of the Closing Agreement

Closing agreements are created by statute and "are authorized, and limited by, the language of the statute." Marathon Oil Co. v. United States, 42 Fed.Cl. 267, 274 (1998), aff'd, 215 F.3d 1343 (Fed. Cir. 1999). When not otherwise limited by the statute, courts apply principles of contract law when analyzing closing agreements. See Marathon Oil Co., 42 Fed. Cl. at 274; Smith v. United States, 850 F.2d 242, 245 (5th Cir. 1988); Rink v. Commissioner, 47 F.3d 168, 171 (6th Cir. 1995); United States v. National Steel Corp., 75 F.3d 1146, 1150 (7th Cir. 1996). "It is a fundamental precept of the common law that the intention of the parties to a contract controls its interpretation." Blue Cross & Blue Shield United of Wis., 71 Fed. Cl. 641, 648 (2006); see Sid Richmond Carbon & Gasoline Co. v. Interenergy Resources, Ltd., 99 F.3d 746, 754 (5th Cir. 1996); JAK Prods., Inc. v. Wiza, 986 F.2d 1080, 1088 (7th Cir. 1993); Vision Info. Servs., Inc. v. Commissioner, 419 F.3d 554, 558 (6th Cir. 2005). If the terms of a contract are clear and unambiguous, courts do not consider extrinsic evidence in interpreting the contract; extrinsic evidence is only allowed if the contract is ambiguous. See Blue Cross & Blue Shield United of Wis., 71 Fed. Cl. at 648; Rink, 47 F.3d at 172; S & O Liquidating Partnership v. Commissioner, 291 F.3d 454, 459 (7th Cir. 2002); cf. Hall v. State Farm Fire & Cas. Co., 937 F.2d 210, 214 (5th Cir. 1991). Under contract law, an interpretation that gives reasonable meaning to all parts of the contract is preferable to one that leaves portions of the contract meaningless. See Temple v. United States, 11 Ct. Cl. 302, 305 (1986); Rink, 47 F.3d at 171; Springer v. Commissioner, T.C. Memo. 2003-221. Provisions in a contract are interpreted in light of the entire agreement. See First Nationwide Bank v. United States, 48 Fed. Cl. 248, 260 n.18 (2000); cf. Tomerlin Trust v. Commissioner, 87 T.C. 876, 881 (1986) (true nature of contract "is to be ascertained from the entire content and thrust of contract provisions").

Introductory clauses "in a closing agreement are important for interpreting the agreement." Zaentz v. Commissioner, 90 T.C. 753, 762 (1988). However, they do not

bind “the parties for purposes of resolving an issue concerning a matter other than the matter agreement upon.” Id.

The Closing Agreement addresses the appropriate LIFO values for Company A’s Pool A as of Date 1, Date 2, Date 3, Date 4, Date 5, Date 6, and Date 7. It does not address the appropriateness of the taxpayer’s item definitions or purport to lock in the taxpayer’s item definitions for perpetuity.

In fact, the language of the agreement is clear that it does not apply to anything that enters inventory after Date 7. The Closing Agreement specifically states:

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The taxpayer attempts to take the statement that the Commissioner out of context. This statement is made in conjunction with a stipulation that the

and as part of an agreement to finalize the calculation of Company A’s pre-Year 2 LIFO inventory. When examined within the framework of the entire agreement, it is apparent that this provision is there to prevent the Commissioner from subsequently changing the inventory calculation by challenging the criteria upon which the calculation is based (and thus circumventing its agreement not to change the pre-Year 2 inventory calculations).

Moreover, the taxpayer’s interpretation is contrary to the intent of the parties as evidenced by the written agreement. An interpretation of the agreement that compels the Commissioner to accept the taxpayer’s LIFO methodology (to the extent it was in place as of Date 7) is contrary to the acknowledgement in the agreement that neither party intended to admit the correctness of the other’s position.

Therefore, while the language of the agreement limits the IRS’s ability to make a section 481(a) adjustment,⁵ it does not prohibit the IRS from changing the taxpayer’s item definitions for years subsequent to Year 1.

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⁵ A change in item definitions is a change in method of accounting under section 446. See Richardson, T.C. Memo. 1996-368. Section 481(a) provides that, in computing the taxpayer’s income for the taxable year in which the change in method of accounting occurs, “there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted.” “[S]ection 481 taxes in the year of change all income omitted in prior years under the old accounting system,” regardless of whether the statute of limitations has

Application of the Closing Agreement to Inventory Obtained from Company B and Company C

Inventory acquired as a result of the merger with Company B or the transfer of the assets from Company C is subject to examination by the IRS even if it was owned by the predecessor companies prior to Date 7. While such inventory was combined with the taxpayer's inventory (including the taxpayer's pre-Year 2 inventory),⁶ it did not enter the taxpayer's inventory until after Date 7. Therefore, it is subject to examination by the IRS as the Closing Agreement provides that the IRS may examine

that enter inventory after Year 1. This position also is supported by the language of the agreement that the Commissioner

Inventory acquired from Company B or Company C is not included on Attachment Y.

In addition, a conclusion to the contrary would allow application of the Closing Agreement to companies who were not parties to the agreement. A person who is not a party to a contract "is in no position to invoke its protection." Hagar v. Reclamation Dist. No. 108, 111 U.S. 701, 712-13 (1884). Third parties do not receive rights under a contract unless the contract reflects the express or implied intent of the parties to benefit the third party. See F.D.I.C. v. United States, 342 F.3d 1313, 1319 (Fed. Cir. 2003). Generally, closing agreements are only binding with respect to the parties thereto. See Schwartz v. Commissioner, T.C. Memo. 1980-212. Although, closing agreements may be binding on transferees. See Pert v. Commissioner, 105 T.C. 370, 376 (1995) (transferee of assets from his wife and her former husband's estate could not challenge the deficiencies and additions to tax that were agreed to by the wife and the estate in a closing agreement when IRS sought to collect from the transferred assets).

Company B and Company C were not parties to the agreement and the agreement does not reflect an intent, express or implied, to include inventory acquired in subsequent mergers, acquisitions, or other corporate transactions within the confines of the Closing Agreement. In fact, the Closing Agreement reflects the opposite intention as it provides that the IRS may examine anything entering into inventory after Date 7.

expired for those years. Graff Chevrolet v. Campbell, 343 F.2d 568, 572 (5th Cir. 1965); cf. Huffman v. Commissioner, 518 F.3d 357 (6th Cir. 2008). Because a section 481(a) adjustment attributable to a change in item definitions would, in part, require a change to the inventory calculation for pre-Year 2 tax years, such adjustment would be in violation of the Closing Agreement. Therefore, any section 481(a) adjustment would be limited to tax years after Year 1.

⁶ Rev. Rul. 70-565, 1970-2 C.B. 110, holds that the LIFO layers and date bases of the transferor's LIFO inventories carry over in a section 351 transaction to an existing transferee also using the LIFO method. Sections 381(c)(5) provides that an acquiring corporation must compute inventories on the same basis used by the distributor or transferor corporation unless different methods were used by the acquiring corporation and the distributor or transferor corporation. If different methods were used and the businesses are to be integrated, then the principal method must be used. Treas. Reg. § 1.381(c)(5)-1(c)(1).

While closing agreements may apply to transferees, Company B and Company C are not transferees. To the extent they are transferors, the same rule does not apply. Binding a transferee precludes a taxpayer from avoiding the application of a closing agreement by transferring assets. To apply this rule conversely would not achieve the same result; rather it would allow application of a closing agreement to taxpayers and items to which it was never meant to apply.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call _____ if you have any further questions.

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